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1. FINANCIAL STATEMENT PRESENTATION

A. Introduction

The accompanying combined financial statements (Statutory Basis Financial Report) of the Commonwealth of Massachusetts (the Commonwealth) are presented in accordance with the requirements of Section 12 of Chapter 7A as amended by Section 4 of Chapter 88 of the Acts of 1997 of the Massachusetts General Laws. The Office of the Comptroller also publishes the Commonwealth's Comprehensive Annual Financial Report (CAFR) which is prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for governments. GAAP is prescribed by the Governmental Accounting Standards Board (GASB), the authoritative standard-setting body for establishing governmental accounting and financial reporting principles.

The Statutory Basis Financial Report (SBFR) includes all the budgeted and non-budgeted funds and account groups of the Commonwealth, as recorded by the Office of the Comptroller in compliance with Massachusetts General Laws and in accordance with the Commonwealth's budgetary principles.

The Statutory Basis Financial Report's General Purpose Financial Statements are not intended to include independent authorities, non-appropriated funds of higher education or other organizations included in the Commonwealth's reporting entity as it would be defined under GAAP.

B. Statutory Basis

The Commonwealth reports its statutory basis financial position and results of operations in funds and account groups, each of which is considered a separate accounting entity. The operations of each fund are accounted for with a set of self-balancing accounts that comprise its assets, liabilities, fund balances, revenues and expenditures/expenses. Transactions between funds within a fund type, if any, have not been eliminated.

Account groups are accounting entities used to provide accountability for the Commonwealth's general fixed assets and long-term obligations. They are not considered funds because they do not report expendable available financial resources and related liabilities.

C. Governmental Fund Types

The Fund types and account groups are organized as follows:

Governmental Fund Types account for the general governmental activities of the Commonwealth.

Budgeted Funds – are the primary operating funds of the Commonwealth. They account for all budgeted governmental transactions. Major budgeted funds include the General, Highway and Local Aid funds which are identified by the Comptroller as the operating funds of the Commonwealth.

Non-Budgeted Special Revenue Funds – are established by law to account for specific revenue sources that have been segregated from the budgeted funds to support specific governmental activities such as federal grants, funds related to the tobacco settlement and the operations of the state lottery.

Capital Projects Funds – account for financial resources used to acquire or construct major capital assets and to finance local capital projects. These

resources are derived from proceeds of bonds and other obligations, which are generally received after related expenditures have incurred, operating transfers authorized by the Legislature and from federal reimbursements. Deficit balances in Capital Projects Funds represent amounts to be financed.

D. *Fiduciary Fund Types*

Fiduciary Funds account for assets held by the Commonwealth in a trustee capacity (Trust Funds), or as an agent (Agency Funds) for individuals, private organizations, other governmental units, and/or other funds.

Expendable Trust Funds – account for trusts whose principal and investment income may be expended for a designated purpose.

Nonexpendable Trust Funds – account for trusts whose principal cannot be spent.

Pension Trust Funds – account for the net assets available for plan benefits held in trust for the State Employees' and Teachers' Retirement Systems.

Agency Funds – account for assets the Commonwealth holds on behalf of others. Agency Funds are custodial in nature and do not involve measurement of operations.

E. *Account Groups*

Account Groups establish control and accountability over the Commonwealth's general fixed assets and long-term obligations.

General Fixed Assets Account Group – accounts for the general fixed assets of the Commonwealth and capital leases.

General Long-term Obligations Account Group – accounts for long-term bonds and notes issued by the Commonwealth and capital leases.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. *Statutory Basis of Accounting*

The Statutory Basis Financial Report is prepared from the Commonwealth's books and records and other official reports which are maintained on the basis of accounting used in the preparation of the Commonwealth's legally adopted annual budget (statutory basis). The statutory basis emphasizes accountability and budgetary control of appropriations. The Statutory Basis Financial Report is not intended to present the Commonwealth's financial condition and results of operations in conformity with GAAP. Under GAAP, the books are accounted for using a current financial resources measurement focus and the modified accrual basis of accounting.

Under the statutory basis of accounting, revenues are generally recognized when cash deposits are received by the Treasury. However, revenues receivable for federal grants and reimbursements are recognized when related expenditures are

incurred. Amounts due from political subdivisions of the Commonwealth are recognized when considered measurable and available. Deeds excise taxes are recognized at the time of collection by the counties and the Commonwealth. Under GAAP, revenues are recognized when they become both measurable and available.

Under the statutory basis of accounting, expenditures are generally recorded when the related cash disbursement occurs. At year-end, payroll is accrued and payables are recognized, to the extent of approved encumbrances, for goods or services received by June 30. Costs incurred under the federally-sponsored Medicaid program, amounts required to settle claims and judgments against the Commonwealth, and certain other liabilities are not recognized until they are encumbered or otherwise processed for payment. Under GAAP, expenditures are recorded in the period in which the related fund liability is incurred.

The Pension Trust Funds are reported using a flow of economic resources measurement focus and the accrual basis of accounting on both the statutory and GAAP basis. Under this method, additions are recorded when earned and deductions are recorded at the time liabilities are incurred. This measurement focus emphasizes the determination of net change in assets available for pension benefits.

The accounting policies followed in preparing the accompanying statutory basis financial report are described in the remainder of this section.

**B. *Cash, Short-term
Investments and
Investments***

The Commonwealth follows the practice of pooling the cash and cash equivalents of its Governmental and Fiduciary Funds. Cash equivalents consist of short-term investments with an original maturity of three months or less and are stated at cost. Interest earned on pooled cash is allocated to the General Fund, Expendable Trust Funds and, when so directed by law, to certain Special Revenue and Capital Projects Funds.

The Commonwealth enters into interest rate swap agreements to modify interest rates on outstanding debt. Other than the net interest expenditures resulting from these agreements no amounts are recorded in the financial statements.

The Pension Trust Funds, with investments of approximately \$25,868,200,000 at fair value, are permitted to make investments in equity securities, fixed income securities, real estate and other alternative investments. For investments traded in an active market, the fair value of the investment will be its market price. The Pension Trust Funds include investments in real estate, venture capital funds, real estate funds, limited partnerships, futures pools, international hedge pools, commodities pools, balanced pools, leveraged buyouts, private placements and other alternative investments. The structure, risk profile, return potential and marketability differ from traditional equity and fixed income investments. Concentration of credit risk exists if a number of companies in which the fund has invested are engaged in similar activities and have similar economic characteristics that could cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. To mitigate the exposure to concentrations of risk, the Pension Trust Funds invest in a variety of industries located in diverse geographic areas. As of June 30, 2002, the estimated fair values, determined by management with input from the investment managers, of these real estate and alternative investments were \$3,500,739,000 of the Pension Trust Funds, representing 11% of the total assets of the Fiduciary Fund Type.

C. *Securities Lending Program*

The Pension Trust Funds participate in securities lending programs. Under these programs, the Trusts receive a fee for allowing brokerage firms to borrow certain securities for a predetermined period of time, securing such loans with cash or collateral typically equaling 102% to 105% of the fair value of the security borrowed. At June 30, 2002, the market value of the securities on loan from the Pension Reserve Investment Trust (PRIT) was approximately \$1,249,322,000. The value of the collateral held by PRIT amounted to \$1,352,713,000 at June 30, 2002. The PRIT securities on loan were collateralized at all times by U.S. Treasury securities of at least 100% of the value.

D. *Receivables*

Receivables are stated net of estimated allowances for uncollectible accounts. Reimbursements due to the Commonwealth for its expenditures on federally funded reimbursement and grant programs are reported as "Due from federal government."

E. *Due from Cities and Towns*

Represents reimbursement due to the Commonwealth for its expenditures on certain programs for the benefit of cities and towns.

F. *Dedicated Revenue*

As part of the General Appropriation Act of 2000 (Chapter 127 of the Acts of 1999,) the funding mechanism for the net cost of service and other costs of the Massachusetts Bay Transportation Authority (MBTA) was changed. This change became effective July 1, 2000. Under the new funding method (Forward Funding), the MBTA's costs are funded on a current basis, rather than 18 months in arrears as had been under previous practice. The method apportions a "dedicated sales tax" amounting to 1% of applicable sales in the Commonwealth directly to the MBTA. The MBTA will also continue to receive amounts assessed on the 175 cities and towns within the service area (assessments.) The assessments totaled \$142,848,000 and \$144,544,000 in FY02 and FY01, respectively. These assessments are projected to decrease yearly to approximately \$136,000,000 by FY06. After FY06, assessments will be adjusted annually by a maximum of 2.5%.

For FY02, the minimum amount due to the MBTA, or "base revenue," was \$664,350,000. In FY02 the dedicated sales tax revenue was less than the base revenue with deposits in the Massachusetts Bay Transportation Authority State and Local Contribution Fund totaling from said taxes approximately \$638,148,000. Pursuant to the enabling statute, quarterly transfers of sales tax revenue deposited into the general and local aid funds totaling \$26,202,000 were transferred to the fund to raise the dedicated sales tax revenue to base revenue. For FY03, the dedicated sales tax will be equal to the greater of the amount raised by the sales tax or the base revenue of \$684,281,000.

The total cost to establish the Forward Funding mechanism was \$948,290,000. Of that amount, \$325,000,000 was funded through the issuance of General Obligation Bonds during FY01 and \$10,540,000 was funded through operating transfers in FY01. During FY01, the Commonwealth appropriated \$27,500,000 to begin the amortization of \$612,750,000 of the remaining deficit in the Highway Capital Projects Fund. During FY02, the Commonwealth bonded for \$300,000,000 of the remaining \$585,250,000. The maximum authorization was also raised to \$585,250,000. For FY03 through FY21, the Commonwealth has the option of either appropriating a level amount annually to fund the remaining cost, or bonding the deficit, to a maximum remaining authorization of \$285,250,000.

G. Inventories

The costs of materials and supplies are recorded as expenditures in Governmental Funds when purchased. Such inventories are not material in total to the financial statements and therefore are not presented.

H. General Fixed Assets

General fixed asset acquisitions are recorded as expenditures in the acquiring fund and capitalized in the General Fixed Assets Account Group in the year purchased. General fixed assets are recorded at historical cost, or at estimated historical cost if actual historical cost is not available. Donated fixed assets are recorded at estimated fair market value at the date of donation.

The cost of normal maintenance and repairs that do not add to the value of the assets or materially extend asset lives are not capitalized. Improvements are capitalized.

The Commonwealth capitalizes all land except land associated with infrastructure. It capitalizes buildings and equipment, including computer software, with a cost in excess of \$100,000 and \$50,000 respectively at the date of acquisition and with an expected useful life greater than one year. For FY01 this threshold was \$15,000 for all fixed assets. Public domain general fixed assets and infrastructure (roads, bridges, tunnels, dams, water and sewer systems, etc.) are not capitalized. Interest incurred during construction is not material and is not capitalized. No depreciation is provided on general fixed assets for FY02.

I. Interfund/Intrafund Transactions

During the course of its operations, the Commonwealth records transactions between funds and/or between departments. On the statutory basis, transactions between Governmental and Fiduciary Fund Types are recorded as adjustments to the funds' cash accounts. As a result, a fund may report a deficiency in cash and short-term investments.

Transactions of a buyer/seller nature between departments within a fund are not eliminated.

Transfers in and out net to approximately \$4,827,000 due to higher education non-appropriated fund activity, which is not included in the combined statements – statutory basis.

J. Risk Management

The Commonwealth does not insure for state employees workers' compensation, casualty, theft, tort claims and other losses. Such liabilities are not recognized on the statutory basis until encumbered and/or processed for payment. For employees workers' compensation, the Commonwealth assumes the full risk of claims filed under a program managed by the Human Resources Division. For personal injury or property damages, Chapter 258 of the Massachusetts General Laws (General Laws) limits the risk assumed by the Commonwealth to \$100,000 per occurrence, in most circumstances. The Group Insurance Commission administers contributory health care and other insurance programs for the Commonwealth's employees and retirees.

The Commonwealth has entered into agreements for insurance for Central Artery/Tunnel Project workers' compensation and certain other claims that may arise in the course of the Project. This special arrangement has been approved by the Federal Highway Administration as a cost-effective method to fund current and potential future claims by contractors, workers, and other parties affected by the project. Pursuant to the agreement, the Commonwealth conveys

a sum of money to an agent each month. This amount includes both federal and state share. The agent manages and settles all claims. At the conclusion of the program, the balance remaining, if any, will be returned to the Commonwealth and the federal government. The monthly amount conveyed to an agent is accounted for (on the statutory basis of accounting) as an expenditure in the Federal Highway Capital Projects Fund.

K. *Encumbrances*

Encumbrance accounting is utilized in the Governmental Fund Types as a significant aspect of budgetary control. The full amounts of purchase orders, contracts and other commitments of appropriated resources are encumbered and recorded as deductions from appropriations prior to actual expenditure, ensuring that such commitments do not exceed appropriations. Encumbrances outstanding at year-end for goods or services received on or before June 30 are reported as expenditures and statutory basis liabilities as a component of accounts payable.

L. *Fringe Benefit Cost Recovery*

The Commonwealth appropriates and pays the fringe benefit costs of its employees and retirees through the General Fund. These fringe benefits include the costs of employees' health insurance, pensions, unemployment compensation, and other costs necessary to support the state work force. As directed by Chapter 29, Sections 5D and 6B(f) of the Massachusetts General Laws, these costs are assessed to other funds based on their payroll costs, net of credits for direct payments. Since these fringe benefit costs are not appropriated in the budget, the required assessment creates a variance between budget and actual expenditures at year-end. The fringe benefit cost recoveries of \$161,524,000 in the budgeted funds result from costs assessments of \$110,667,000 in the governmental fund types and the expendable trust funds. The remainder of \$50,857,000 is assessed to the higher education non-appropriated activity which is not included in the statutory basis financial report.

M. *School Construction Grants*

The Commonwealth, through legislation, is committed to reimburse certain cities, towns and regional school districts for a portion of their debt service costs for school construction and renovation. These costs are recorded as expenditures when paid.

N. *Compensated Absences*

Employees are granted vacation and sick leave in varying amounts based on collective bargaining agreements and state laws. Upon retirement, termination or death, certain employees are compensated for unused vacation and sick leave (subject to certain limitations) at their then-current rate of pay. Vacation and sick leave are recorded as expenditures when paid.

O. *Lottery Revenue and Prizes*

Ticket revenues are recognized when sold and prizes awarded by the Massachusetts Lottery Commission are recognized as drawings are held.

P. *Fund Balances*

The Commonwealth reports fund balances as reserved where legally restricted for a specific future use. Otherwise, these balances are considered unreserved.

Fund balance has been reserved as follows:

"Reserved for continuing appropriations" – are unexpended amounts in appropriations which the Legislature has specifically authorized to be carried into the next FY.

“Reserved for Commonwealth stabilization” – are amounts set aside in the Commonwealth Stabilization Fund in accordance with 5C of Chapter 29 of Massachusetts General Laws.

“Reserved for tax reduction” - are amounts set aside in the Tax Reduction Fund according to Section 6 of Chapter 29B of the Massachusetts General Laws.

“Reserved for transitional escrow” –for FY01, amounts were reserved until November 30, 2001 under Chapter 88, Section 36 of the Acts of 2001.

“Reserved for debt service” – are amounts held by fiscal agents or the Commonwealth to fund future debt service obligations.

“Reserved for employees’ pension benefits” – are the net assets of the Commonwealth’s public employee retirement systems which cannot be used for any other purpose.

“Reserved for unemployment benefits” – are amounts reserved for payment of unemployment compensation.

“Reserved for capital projects” - are amounts reserved for capital projects.

Unreserved fund balance is segregated into two components:

“Designated for specific purpose” – are all unreserved fund balances for which the Legislature or Executive Branch has evidenced an intention to restrict for a specific purpose.

“Undesignated” – consists of cumulative surpluses or deficits of the Governmental Fund Types not otherwise designated.

Q. *Reclassification*

Certain reclassifications have been made to the FY 2001 account balances to conform to the presentation used in FY02.

3. BUDGETARY CONTROL

State finance law requires that a balanced budget be approved by the Governor and the Legislature. The Governor presents an annual budget to the Legislature which includes estimates of revenues and other financing sources and recommended expenditures and other financing uses. The Legislature, which has full authority to amend the budget, adopts an expenditure budget by appropriating monies at the individual appropriation account level in an annual appropriations act.

Before signing the appropriations act, the Governor may veto or reduce any specific item, subject to legislative override. Further changes to the budget established in the annual appropriations act may be made via supplemental appropriations acts or other legislative acts. These must also be signed by the Governor and are subject to the line item veto.

In addition, Massachusetts General Laws authorize the Secretary of Administration and Finance, with the approval of the Governor, upon determination that available revenues will be insufficient to meet authorized expenditures, to withhold allotments of appropriated funds which effectively reduce the account’s expenditure budget.

The majority of the Commonwealth's appropriations are non-continuing accounts which lapse at the end of each fiscal year. Others are continuing accounts for which the Legislature has authorized that an unspent balance from the prior year be carried forward and made available for spending in the current fiscal year. In addition, the Legislature may direct that certain revenues be retained and made available for spending within an appropriation. Fringe benefits and other costs which are mandated by state finance law are not itemized in the appropriation process and are not separately budgeted.

The original FY02 appropriations act, Chapter 177, Acts of 2001, authorized \$21,238,263,000 in direct appropriations. In addition, the act contained \$975,257,000 in authorizations to retain and expend certain non-tax revenues of which \$970,218,000 were estimated to be collected and expended. The Act and supplemental appropriations also included \$135,158,675 in interagency chargebacks. Chapter 177 included estimates of \$14,929,954,500 in tax revenues and approximately \$6,860,600,000 in non-tax revenues. With these revenues (exclusive of chargebacks) projected to total approximately \$21,790,554,500 and with unreserved balances of approximately \$369,500,000 (exclusive of the Mosquito and Greenhead Fly Control Fund which became a non-budgeted fund in FY02) carried forward from the FY01, the budget as presented in this original appropriation act was considered to be in balance.

During FY02, the Legislature also passed and the Governor signed, with some modification through veto, Chapters 183 - 199, Chapters 203 and 220 of the Acts of 2001 and Chapter 118 of the Acts of 2002, which included numerous supplemental budgetary appropriations. These supplements added \$512,919,000 of indirect appropriations and \$111,856,660 in retained revenue authorizations.

Subsequent to June 30, 2002, the Legislature passed and the Governor signed Chapters 300 of the Acts of 2002, which included \$45,798,509 in additional supplemental appropriations and \$3,116,500 in additional retained revenue authorizations. The cumulative FY02 appropriations, retained revenues and interagency chargebacks totals \$23,068,792,000. Appropriations continued from FY01 totaled approximately \$290,029,000 and certain interfund transfers directed by statute totaled approximately \$1,674,382,000.

Because revenue budgets are not updated subsequent to the original appropriation act, the comparison of the initial revenue budget to the subsequent, and often modified, expenditure budget can be misleading. Also, these financial statements portray fund accounting with gross inflows and outflows, thus creating a discrepancy to separately published budget documents. In conducting the budget process, the Commonwealth excludes those interfund transactions that by their nature have no impact on the combined fund balance of the budgeted funds.

Generally, expenditures may not exceed the level of spending authorized for an appropriation account. However, the Commonwealth is statutorily required to pay debt service, regardless of whether such amounts are appropriated.

During FY02, the Commonwealth experienced a significant downturn in certain tax revenues. The revenue estimates, under the provisions of section 5D of Chapter 29 of the General Laws, were determined to be insufficient to meet all of the expenditures authorized to be made for FY02. Therefore, in accordance with section 9C of said Chapter 29, the Secretary for Administration and Finance notified the Governor and the House and Senate Committees on Ways

and Means of the amount of the probable deficiency of revenue. In accordance with her authority under said section 9C, the Governor reduced allotments under section 9B of said Chapter 29. The amount of this reduction was \$120,256,891.

The following table identifies this interfund activity from the budgeted sources and uses to reconcile forecasts prepared during the budget process to the detailed fund accounting of the Commonwealth's statutory financial statements (amounts in thousands):

	Revenues and Other Financing Sources	Expenditures and Other Financing Uses
Actual as presented in the combined budget and actual statement - statutory basis.....	\$ 23,049,348	\$ 24,674,686
Adjustments to revenues and expenditures		
Transfer to the Intragovernmental		
Service Fund Revenues.....	(115,226)	(115,226)
Adjustments to other financing sources and uses:		
Fringe benefit cost assessments.....	(53,267)	(53,267)
Transfer from the Intragovernmental		
Service Fund to the General Fund.....	(1,112)	(1,112)
Transfer from the Revenue Maximization		
Fund to the General Fund.....	(6,602)	(6,602)
RMV License Plates.....	(1,735)	(1,735)
Transfer from the General Fund to the		
Children's and Seniors Health Fund.....	(36,952)	(36,952)
Stabilization transfers.....	(1,030,000)	(1,030,000)
Transfer from the Transitional Escrow Fund		
to the General Fund and Stabilization Fund.....	(579,215)	(579,215)
Transfer from the Voting Equipment Loan Fund to		
the General Fund	(1,397)	(1,397)
Transfer from the Tax Reduction Fund to		
the General Fund	(33,605)	(33,605)
Debt Service Reimbursement from the MWRA	(10,342)	(10,342)
Transfer to Caseload Mitigation Increase Fund.....	(4,878)	(4,878)
Other	(100)	(100)
Actual as presented on budgetary documents.....	<u>\$ 21,174,917</u>	<u>\$ 22,800,255</u>

The section divider for the budgeted funds contains a list of budgeted funds grouped by categories.

The Office of the Comptroller has the responsibility to ensure that budgetary control is maintained on an individual appropriation account basis. Budgetary control is exercised through the state accounting system, Massachusetts Management Accounting and Reporting System (MMARS). Encumbrances and expenditures are not allowed to exceed the appropriation account's spending authorization.

4. DEPOSITS AND INVESTMENTS

The Commonwealth maintains a cash and short-term investment pool that is available for use by all funds. Each fund type's net equity in this pool is displayed on the combined balance sheet as either "Cash and short-term investments" or "Deficiency in cash and short-term investments." The investments of the Pension Trust Funds are held in a trust.

The Office of the Treasurer and Receiver-General (Treasury) manages the Commonwealth's short-term investment pool. Statutes authorize investment in obligations of the U.S. Treasury, authorized bonds of all states, banker's acceptances, certificates of deposit, commercial paper rated within the three highest classifications established by Standard & Poor's Corporation and Moody's Commercial Paper Record and repurchase agreements that any of these obligations secure. Such investments are carried at cost, which approximates fair value.

The pooled cash and short-term investments at June 30, 2002 are as follows (amounts in thousands):

	<u>Carrying Value</u>
Cash and Certificates of deposit.....	\$ 573,678
Short-term investments:	
Short-term investment pool.....	3,461,927
Repurchase agreements and other.....	3,745
Money market investments.....	902,907
Total.....	<u>\$ 4,942,257</u>

Pooled cash and short-term investments include the following:

Cash and short-term investments.....	\$ 6,659,568
Cash with fiscal agent.....	343,333
Deficiency in cash and short-term investments.....	<u>(2,060,644)</u>
Total.....	<u>\$ 4,942,257</u>

The Pension Trust Funds have invested a significant portion of their portfolios into a trust, which pools assets for investment purposes and allocates returns on these investments in proportion to each fund's share of the pool. The fund include money held on behalf of other governments.

The investments are carried at fair value. At June 30, 2002, they are as follows (amounts in thousands):

	<u>Amount</u>
Investments:	
Equity securities.....	\$ 10,174,847
International investments.....	6,005,485
U.S. government and government agency securities.....	4,482,760
Fixed income securities.....	2,671,427
Real estate.....	1,850,346
Alternative investments.....	1,650,393
Total.....	<u>\$ 26,835,258</u>

On behalf of the Health Care Security Trust Fund, the Pension Reserve Management Board has invested a significant portion of their portfolios into a trust, which pools assets for investment purposes and allocates returns on these investments in proportion to the fund's share of the pool.

The investments are carried at fair value. At June 30, 2002, they are as follows (amounts in thousands):

	Amount
Investments:	
Equity securities.....	\$ 240,277
U.S. government and government agency securities.....	93,953
International investments.....	77,978
Fixed income securities.....	58,421
Real estate.....	10,781
Total.....	<u>\$ 481,410</u>

**A. Financial Instruments
with Off-Balance Sheet
Risk**

Certain investments of the Commonwealth may involve a degree of risk not accounted for on the respective financial statements. A description of such "off-balance sheet risks" are as follows:

**B. Forward Currency
Contracts**

The Pension Trust Funds enter into forward currency contracts to hedge the exposure to change in foreign currency exchange rates on foreign portfolio holdings. The market value of the contract will fluctuate with changes in currency exchange rates. Risks may arise upon entering these contracts from the potential inability of counterparties to meet the terms of their contracts and from unanticipated movements in the value of a foreign currency relative to the U.S. dollar.

When the contract is closed, the Pension Trust Funds record a realized gain or loss equal to the difference between the value of the contract at the time it was opened and the value at the time it was closed. Fluctuations in the value of forward currency contracts are recorded as unrealized gains or losses by the Pension Trust Funds.

C. Future Contracts

The Pension Trust Funds may purchase and sell financial futures contracts to hedge against changes in the values of securities the fund owns or expects to purchase. Upon entering such contracts, they must pledge to the broker an amount of cash or securities equal to a percentage of the contract amount.

The potential risk is that the change in the value of futures contracts primarily corresponds with the value of underlying instruments, which may correspond to the change in value of the hedged instruments. In addition, there is a risk that PRIT may not be able to close out its future positions due to a non-liquid secondary market. Risks may arise from the potential inability of a counterparty to meet the terms of a contract and from unanticipated movements in the value of a foreign currency relative to the U.S. dollar. The Pension Trust Funds may also invest in financial futures contracts for non-hedging purposes.

Payments are made or received by the Pension Trust Funds each day, depending on the daily fluctuations in the value of the underlying security and are recorded as unrealized gains or losses. When the contracts are closed, the Pension Trust Funds recognize a realized gain or loss.

D. Options

PRIT is also engaged in selling or “writing” options. The Pension Trust Funds, as writers of options, may have no control over whether the underlying securities may be sold (call) or purchased (put) and, as a result, bears the market risk of an unfavorable change in the price of the security underlying the written option. As of June 30, 2002, there were no material options outstanding.

5. SHORT-TERM FINANCING AND CREDIT AGREEMENTS

Massachusetts General Laws authorize the Treasurer to issue temporary notes in anticipation of revenue or bond financing. When this short-term debt does not meet long-term financing criteria, it is classified as a fund liability. Short-term debt may be issued on either a stand-alone basis or through a commercial paper program maintained by the Commonwealth.

A. General Fund

The balance of revenue anticipation notes (RANs) outstanding may fluctuate during a fiscal year, but must be reduced to zero at June 30. During FY02, the Commonwealth issued RANs through its commercial paper program on a periodic basis to meet cash flow needs. Up to \$683,000,000 of RANs were issued during the year. All RANs were retired before the end of May, 2002.

B. Capital Projects Funds

The Commonwealth may issue bond anticipation notes (BANs) to temporarily finance its capital projects. BANs may be issued either on a stand-alone basis or through the Commonwealth’s commercial paper program.

During FY02 the Commonwealth periodically issued BANs through the commercial paper program, beginning in August 2001. BANs were rolled over and paid down at various times during the fiscal year. No more than \$300,000,000 of BANs were outstanding under the commercial paper program at any time and all BANs were retired before the end of February, 2002.

During FY02, the Commonwealth also sold BANs on a stand-alone basis. On September 5, 2001, \$350,000,000 of General Obligation BANs were issued to finance costs associated with the development of Convention Centers in Boston, Worcester and Springfield, and to retire a portion of BANs issued prior to the sale. The BANs mature on September 1, 2003.

On March 28, 2002, \$180,000,000 of General Obligation BANs were issued. The BANs, issued to finance costs of the Central Artery / Tunnel Project, in advance of receiving certain contributions from the Massachusetts Port Authority (Massport), mature on April 25, 2003. The amount remaining to be paid by Massport totals approximately \$205 million, payable in three installments of approximately \$105 million, \$50 million and \$50 million on December 31, 2002, 2003 and 2004, respectively. Due to the events of

September 11, 2001, Massport has experienced significant reductions in revenues and operations, as well as increases in certain expenses. The duration of these circumstances cannot be known. Massport has advised the Commonwealth that it does not expect to issue bonds to meet its December 2002 obligation until the summer of 2003. The Commonwealth has agreed to reschedule the payment due from Massport. The FY03 general appropriation act has provisions for the Commonwealth to charge Massport interest costs related to this transaction due to the delay in payment.

C. Letter-of-Credit Facilities

During FY02, the Commonwealth maintained a letter-of-credit agreement with a bank in order to provide credit and liquidity support for its commercial paper program. The letter of credit was available to secure up to \$200,000,000 of Commonwealth commercial paper plus interest thereon. Advances were available, subject to certain limitations and bearing interest at the bank rate as defined, in anticipation of revenue or bond proceeds repayable by the following

June 30, subject to extension in certain circumstances at the Commonwealth's option. No such advances were drawn during the fiscal year ended June 30, 2002. The existing letter of credit facility expires on December 28, 2003. The cost of the facility is approximately 0.15% on both unutilized and utilized amounts.

D. Line-of-Credit Facilities

During FY02, the Commonwealth maintained line-of-credit facilities to provide liquidity support for commercial paper notes. The total of such facilities was increased from \$400,000,000 to \$800,000,000 during the course of the fiscal year. The Commonwealth has a total of four line-of-credit facilities to provide such liquidity support for each in the amount of \$200,000,000. These facilities expire in September and December of 2004, and March and September of 2005 respectively. The cost of these facilities ranges from 0.125% to 0.17%.

The following schedule details short – term financing and credit agreement activity for all funds for the fiscal year (amounts in thousands):

	Bonds Outstanding	Authorized and Unissued
Balance July 1, 2001	\$ 13,999,454	\$ 9,290,418
General and special obligation bonds:		
Principal, less discount and issuance costs	1,486,314	(1,486,314)
Principal issued for sinking fund	11,645	-
Net premium and issuance costs	(27,687)	-
General obligation refunding bonds:		
Principal on Refunding Bonds	1,176,990	-
Principal on Refunded Bonds	(1,168,626)	-
Retired discount on Refunded Bonds	(13,794)	-
Special obligation refunding bonds:		
Principal on Refunding Bonds	183,180	-
Principal on Refunded Bonds	-	-
Increase in bonds authorized	-	679,554
Bonds retired	(692,341)	-
Balance June 30, 2002	<u>\$ 14,955,135</u>	<u>\$ 8,483,658</u>

6. LONG-TERM DEBT

Under the Constitution of the Commonwealth of Massachusetts, the Commonwealth may borrow money (a) for defense, (b) in anticipation of receipts from taxes or other sources, any such loan to be paid out of the revenue of the year in which the loan is made, or (c) by a two-thirds vote of the members of each house of the Legislature present and voting thereon. The Constitution further provides that borrowed money shall not be expended for any other purpose than that for which it was borrowed or for the reduction or discharge of the principal of the loan. In addition, the Commonwealth may give, loan or pledge its credit by a two-thirds vote of the members of each house of the Legislature present and voting thereon, but such credit may not in any manner be given or loaned to or in aid of any individual, or of any private association, or of any corporation which is privately owned or managed.

The Commonwealth has waived its sovereign immunity and consented to be sued on contractual obligations, including bonds and notes issued by it and all claims with respect thereto. However, the property of the Commonwealth is not subject to attachment or levy to pay a judgment, and the satisfaction of any judgment generally requires legislative appropriation. Enforcement of a claim for the payment of principal or interest on bonds and notes of the Commonwealth may also be subject to the provisions of federal or Commonwealth statutes, if any, enacted to extend the time for payment or impose other constraints upon enforcement.

As of June 30, 2002, the Commonwealth had three types of long-term debt outstanding.

A. General Obligation Bonds

General Obligation Bonds are authorized and issued primarily to provide funds for Commonwealth-owned capital projects and local government improvements. They are backed by the full faith and credit of the Commonwealth and paid from the Governmental Funds, in which debt service principal and interest payments are appropriated. Massachusetts General Laws provide for the allocation of bond proceeds to these authorizations in arrears, as expenditures are made, unless the proceeds are allocated at the time of issuance.

i. College Opportunity Bonds

Some Commonwealth general obligation debt is issued as College Opportunity Bonds (COBs) as authorized by the Massachusetts General Laws. Such bonds were initially issued in fiscal year 1996, and have been issued in each subsequent fiscal year, including FY02, when approximately \$5,636,000 of such bonds were issued. Outstanding COBs have maturity dates ranging from 2002 through 2021. COBs have an accreting interest component payable at maturity. The annual accretion rate of each COB's maturity is a variable rate equal to the change in annual Consumer Price Index (CPI) plus 2.0%. Assuming the CPI averages 3.5% during the life of the outstanding COBs the payments due at maturities of the COBs will total approximately \$174,157,000. In addition, COBs pay current interest in the amount of 0.5% per year of the initial amount still outstanding. The full faith and credit of the Commonwealth back these bonds. These bonds are sold to fund the Commonwealth's "U. Plan" which is part of a college savings program administered by the Massachusetts Educational Financing Authority. These bonds are privately placed and are structured to meet the needs of investors in this plan.

ii. County Debt Assumed

Chapter 38 of the Acts of 1997 and Chapter 300 of the Acts of 1998 abolished governments of several Massachusetts counties on various effective dates. As

part of these provisions, the Commonwealth assumed the outstanding debt of Middlesex County on July 1, 1997, of Hampden and Worcester Counties on July 1, 1998, that of Essex County on July 1, 1999 and that of Berkshire County on July 1, 2000. The county debt assumed has become general obligation debt of the Commonwealth. As of June 30, 2002, \$1,115,000 of these obligations remains outstanding.

B. *Special Obligation Bonds*

The Commonwealth also issues special obligation revenue bonds as authorized by Massachusetts General Laws. Such bonds may be secured by all or a portion of revenues credited to the Highway Fund and are not general obligations of the Commonwealth. At June 30, 2002, the Commonwealth had outstanding \$837,910,000 of such special obligation bonds, of which \$772,812,000 is allocated to debt not subject to the Commonwealth's statutory debt limit. These bonds are secured by a pledge of 6.86 cents of the 21 cent motor fuel excise tax imposed on gasoline.

In June of 2002, the Commonwealth sold \$319,130,000 of special obligation revenue bonds, Series 2002A. Of this amount, \$183,180,000 was issued to refund prior special obligation bonds. The remainder was used to fund capital spending in the Commonwealth. The escrow funded by the refunding bonds and related premium will be used only to secure the principal related to \$190,075,000, exclusive of related call premium in previously issued special obligation bonds maturing on June 1, 2003, 2004, 2006 and 2008. The interest related to these maturities is not secured by this escrow. Rather, it will be paid from the existing stream of motor fuel excise taxes. Interest on a portion of the newly issued refunding bonds will be paid from the proceeds of the escrow until the aforementioned prior bonds are called for redemption. This technique, which is generally referred to as a "crossover refunding," results in economic savings to the Commonwealth similar to a normal refunding, but does not meet the accounting definition of defeasance of debt, in which case the defeased debt and the related escrow accounts would have been removed. Until such time as the escrow is used to repay the principal of the refunded bonds, such amounts will be reported in the Highway Capital Projects Fund.

C. *Federal Highway Grant Anticipation Notes (GANs)*

The Commonwealth also issues Federal Highway GANs to finance current cash flow for the Central Artery/Tunnel Project in anticipation of future federal reimbursements. Section 9 through 10D of Chapter 11 of the Acts of 1997, as amended by Chapter 121 of the Acts of 1998, authorizes the Commonwealth to sell up to \$1,500,000,000 in GANs. All Federal Highway Construction reimbursements and reimbursements from the federal highway construction trust funds are pledged to the repayment of the GANs. At June 30, 2002, the Commonwealth has \$1,499,325,000 of GANs outstanding, including accrued interest on capital appreciation bonds with maturity dates ranging from 2005 to 2015. These notes are secured by the pledge of Federal Highway Construction Reimbursements without a general obligation pledge. Under certain limited circumstances, a portion of the revenue from the Commonwealth's motor fuels excise tax may be used to pay debt service on the GANs.

D. *Variable Rate Demand Bonds*

Included in the long-term debt is \$1,542,600,000 of general obligation variable rate demand bonds (VRDBs) maturing from 2007 through 2030 in varying amounts. The redemption schedule for these bonds is included in the bond redemption schedule contained herein. The interest rate on the VRDBs is determined either weekly or daily based on the activity of the Commonwealth's remarketing agents, and interest is paid monthly. On any reset date holders of the VRDBs can require the Commonwealth (acting through its remarketing and tender agents) to repurchase the bonds (a "put"). The remarketing agent is

authorized to use its best efforts to resell any repurchased bonds by adjusting the interest rates offered. The Commonwealth pays an annual fee to the remarketing agents equal to 0.05% of the par amount of the bonds.

Under the provisions of stand-by bond-purchase agreements entered into by the Commonwealth with certain commercial banks, the remarketing and tender agents are entitled to draw amounts sufficient to pay the purchase price of any bonds that cannot be resold. During any such period the Commonwealth is required to pay the bank(s) at an interest rate based on their respective prime lending rates. If the remarketing agent is unable to resell any put bonds within six months of the put date, the stand-by bond-purchase agreements include provisions to convert any such bonds to installment loans payable over an extended period of time, with interest payable at a rate based on the bank(s) prime lending rate(s). The stand-by bond-purchase agreements expire on various dates between September of 2003 and February of 2006. The Commonwealth is required to renew or replace these agreements as long as the VRDBs remain outstanding. The Commonwealth currently pays an annual fee to maintain these agreements which ranges from 0.10% to 0.18% of the par amount of the bonds.

E. Interest Rate Swap Agreements

As of June 30, 2002, \$1,267,000,000 of the VRDBs have been issued as general obligation refunding bonds. In connection with the issuance of such refunding bonds, the Commonwealth has entered into interest rate exchange ("swap") agreements with certain counterparties. These agreements require the counterparties to pay the Commonwealth an amount equal to the variable rate payable on the bonds and in return the Commonwealth pays a specified fixed rate. Only the net difference in interest payments is exchanged with the counterparty. The potential risk is that the variable rate will fall below the fixed rate established under this agreement. The Commonwealth continues to pay interest to the bondholders at the applicable variable rates. Through these agreements the Commonwealth has effectively fixed its interest rate payment obligations on the relevant VRDBs at rates ranging from 4.15% to 4.659%, not including the cost of liquidity and remarketing. The Commonwealth will be exposed to a variable rate if the counterparties default or if the swap is terminated. A termination of the swap may also result in the Commonwealth making or receiving a termination payment.

F. Auction Rate Securities

Also included in the long-term debt is \$401,500,000 of general obligation Auction Rate Securities (ARS) maturing in varying amounts from 2020 through 2030. The interest rate payable on the bonds changes weekly as determined pursuant to specified auction procedures. Interest on the bonds is payable weekly. In the case of a failed auction (i.e., insufficient bids to clear the market) existing buyers may be required to hold their bonds with interest payable at rate equal to a percentage of an ARS industry index.

G. Outstanding Debt

For financial reporting purposes, long-term debt is carried at its face value, which includes discount and any issuance costs. The outstanding amount represents the total principal to be repaid. For capital appreciation bonds, the outstanding amount represents total principal and accreted interest to be repaid. When short-term debt has been refinanced on a long-term basis, it is reported as outstanding at its face amount.

The amount of long-term debt authorized but unissued is measured in accordance with the statutory basis of accounting. Only the net proceeds (exclusive of discount and costs of issuance) are deducted from the total authorized by the Legislature.

Long-term debt outstanding (including discount and issuance cost) and debt authorized and unissued at June 30, 2002 as follows (amounts in thousands):

<u>Purpose</u>	<u>Bonds Outstanding</u>	<u>Maturities</u>	<u>Authorized and Unissued</u>
G A N S.....	\$ 1,499,325	2005-2015	\$ -
Capital Projects:			
General.....	5,067,282	2002-2022	3,272,250
Highway.....	7,022,375	2002-2032	4,197,371
Local Aid.....	1,305,743	2002-2022	147,099
Other.....	60,410	2002-2022	866,938
	<u>13,455,810</u>		<u>8,483,658</u>
Total.....	<u>\$ 14,955,135</u>		<u>\$ 8,483,658</u>

Interest rates on the Commonwealth's debt outstanding at the end of FY02 ranged from 0.1% to 8.0%.

Changes in long-term debt outstanding (including discount and issuance cost) and bonds authorized - unissued for the year ended June 30, 2002 are as follows (amounts in thousands):

Fiscal Year Ended

<u>June 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2003.....	\$744,830	\$739,821	\$1,484,651
2004.....	757,020	700,456	1,457,476
2005.....	822,162	666,861	1,489,023
2006.....	944,752	625,151	1,569,903
2007.....	983,127	577,368	1,560,495
2008-2012.....	4,848,232	2,123,589	6,971,821
2013-2017.....	3,567,934	997,514	4,565,448
2018-2022.....	1,692,925	359,574	2,052,499
2023-2027.....	233,399	126,947	360,346
2028-2032.....	<u>360,755</u>	<u>35,532</u>	<u>396,287</u>
Total	<u>\$14,955,135</u>	<u>\$6,952,813</u>	<u>\$21,907,949</u>

At June 30, 2002, debt service requirements to maturity for principal (including discount, capital appreciation and issuance costs) and interest are as follows (amounts in thousands):

	<u>Capital Leases</u>		<u>Operating</u>	<u>Total</u>
	<u>Principal</u>	<u>Interest</u>	<u>Leases</u>	
2003.....	\$43,245	\$6,512	\$140,509	\$190,266
2004.....	37,731	5,550	112,605	155,886
2005.....	31,103	4,531	92,118	127,752
2006.....	24,281	3,574	51,331	79,186
2007.....	18,992	2,717	22,590	44,299
2008-2012.....	26,589	3,325	60,203	90,117
2013-2017.....	429	54	1,279	1,762
2018-2022.....	168	21	506	695
Total.....	<u>\$182,538</u>	<u>\$26,284</u>	<u>\$481,141</u>	<u>\$689,963</u>

The Commonwealth issued bonds and notes through both competitive and negotiated sales during FY02. The costs for legal counsel and underwriting fees (including estimated amounts related to competitive sales) for bond sales were \$593,000 and \$14,327,000 respectively. In addition, the Commonwealth paid \$186,000 for disclosure counsel services.

H. Bonds Defeased Through Refunding

As authorized by the Massachusetts General Laws, the Commonwealth advance refunded certain general obligation bonds through the issuance of \$1,176,990,000 of general obligation refunding bonds (exclusive of the aforementioned special obligation refunding bonds) during FY02. Net proceeds totaling approximately \$1,267,751,000 were used to purchase U.S. Government and U.S. Government Agency securities which were deposited in irrevocable trusts with an escrow agent to provide for all future debt service payments of the refunded bonds. As a result, the refunded bonds are considered to be defeased, and the liabilities therefore have been removed from the General Long-term Obligations Account Group. As a result of this refunding, the Commonwealth decreased current year debt service payments and has taken advantage of lower interest rates, and it has decreased its aggregate debt service payments by approximately \$55,013,000 over the next 20 years and will experience an economic gain (the difference between the present values of the debt service payments of the refunded and refunding bonds) of approximately \$47,141,000. At June 30, 2002, approximately \$1,090,330,000 of the bonds refunded remain outstanding and are defeased.

I. Prior Defeasance

In prior years, the Commonwealth defeased certain general and special obligation bonds by purchasing securities (from the proceeds of refunding bonds or from surplus operating funds) and placing them in irrevocable trusts to provide for all future debt service payments on the defeased bonds. Accordingly, the trust account assets and the liabilities for the defeased bonds are not included in the financial statements. At June 30, 2002, approximately \$2,286,432,000 of bonds outstanding from activities in prior fiscal years are considered defeased.

J. Statutory Debt Limit

The Massachusetts General Laws establish limits on the amount of direct debt outstanding. By statutorily limiting the Commonwealth's ability to issue direct debt, this limit provides a control on annual capital spending. The direct debt

limit for FY02 was approximately \$11,630,307,000. Outstanding debt subject to the limit at June 30, 2002 was approximately \$11,014,062,000. The limit increases 5% per year.

For purposes of determining compliance with the limit, outstanding direct debt is defined to include general obligation bonds and minibonds at the amount of their original net proceeds. It excludes BANs and discount and issuance costs, if any, financed by these bonds. It also excludes special obligation bonds, GANs, refunded bonds, certain refunding bonds, debt issued by counties, and debt issued in conjunction with the MBTA forward funding.

The amounts excluded from the debt limit are as follows (amounts in thousands):

	<u>Debt Outstanding</u>
Balance June 30, 2002.....	\$ 14,955,135
Less amounts excluded:	
Discount and issuance cost.....	(181,910)
Chapter 5 of the Acts of 1992 Refunding..	(22,043)
Special Obligation Principal.....	(772,812)
GANs Principal.....	(1,500,000)
County Debt Assumed.....	(1,115)
MBTA Forward Funding.....	(625,000)
Central Artery Tunnel.....	(838,193)
Outstanding Direct Debt.....	<u>\$ 11,014,062</u>

K. Subsequent Bond Issuances

Subsequent to year-end, the Commonwealth sold nearly \$2.5 billion in debt and priced an additional \$658 million in debt that will be delivered at various times from November 2002 to May of 2003. Of these amounts, \$820 million will be used to fund capital projects, while the remainder will fund refunding escrows, taking advantage of historically low interest rates. This refunding activity will lower the Commonwealth's aggregate debt service payments by approximately \$122.1 million over the next 19 years, resulting in a present value debt service savings of approximately \$95.2 million.

7. LEASES

In order to finance the acquisition of equipment the Commonwealth has entered into various lease/purchase agreements, including tax-exempt lease purchase (TELP) agreements, which are accounted for as capital leases. Lease agreements are for various terms and contain clauses indicating that their continuation is subject to appropriation by the Legislature. For the fiscal year ended June 30, 2002, capital lease/purchase expenditures totaled approximately \$43,080,000.

At June 30, 2002, the Commonwealth's aggregate outstanding liability under capital leases, the present value of the net minimum lease payments, totals approximately \$182,538,000. This liability is reported in the General Long-Term Obligations Account Group. Equipment acquired under capital leases and included in the General Fixed Assets Account Group totaled approximately \$182,281,000.

The Commonwealth has numerous operating lease agreements for real property and equipment with varying terms. These agreements contain provisions indicating that continuation is subject to appropriation by the Legislature.

Operating lease expenditures for the fiscal year ended June 30, 2002 were approximately \$204,211,000.

The following is a schedule of future minimum payments under non-cancelable leases as of June 30, 2002 (amounts in thousands):

Actuarial Valuation as of January 1	Actuarial Value of Plan Assets	Actuarial Accrued Liability	Unfunded Actuarial Liability (UAL)	Funded Ratio %	Annual Covered Payroll *	UAL as a % of Covered Payroll
State Employees' Retirement System						
2002	\$ 15,002,000	\$ 15,961,000	\$ 959,000	94.0 %	\$ 4,034,000	23.8 %
2001	13,922,000	15,170,000	1,248,000	91.8	3,700,000	33.7
2000	13,364,000	14,138,000	773,000	94.5	3,472,000	22.3
1998	9,914,000	11,361,000	1,447,000	87.3	3,111,000	46.5
1996	7,366,000	9,441,000	2,075,000	78.0	2,989,000	69.4
1995	5,879,000	8,602,000	2,723,000	68.3	2,992,000	91.0
1993	5,071,000	8,738,000	3,667,000	58.0	2,919,000	125.6
1992	4,699,000	7,303,000	2,604,000	64.3	2,638,000	98.7
Teachers' Retirement System						
2002	15,712,000	20,620,000	4,908,000	76.2	4,264,000	115.1
2001	14,390,000	18,170,000	3,779,000	79.2	4,072,000	92.8
2000	13,681,000	16,420,000	2,739,000	83.3	3,704,000	73.9
1998	10,170,000	13,095,000	2,925,000	77.7	3,175,000	92.1
1996	7,553,000	10,252,000	2,699,000	73.7	2,810,000	96.0
1995	6,014,000	9,712,000	3,698,000	61.9	2,667,000	138.7
1993	5,142,000	8,921,000	3,779,000	57.6	2,428,000	155.6
1992	4,784,000	8,706,000	3,922,000	55.0	2,032,000	193.0
Boston Teachers						
2002	984,000	1,756,000	772,000	56.0	370,000	208.6
2001	918,000	1,502,000	583,000	61.1	304,000	191.8
2000	860,000	1,381,000	521,000	62.3	285,000	182.8
1998	699,000	1,219,000	520,000	57.3	285,000	182.5
1996	549,000	1,025,000	476,000	53.6	274,000	173.7
1995	438,000	833,000	395,000	52.6	232,000	170.3
1993	370,000	743,000	373,000	49.8	206,000	181.1
1992	342,000	759,000	417,000	45.1	184,000	226.6

8. INDIVIDUAL FUND DEFICITS

In order to resolve the deficits in the budgeted funds, the Comptroller has recommended authorization of transfers from other budgeted funds with surplus balances or a plan of fund consolidation. If these changes are adopted by the Legislature, the deficiencies will be resolved. For the Non-Budgeted Special Revenue Funds, the Comptroller has recommended similar budgeted transfers to subsidize and resolve the deficits or their consolidation into budgeted funds. Such steps require legislative action.

The Capital Projects Fund deficit reported in the following table reflects the time lag between capital expenditures and the sale of related bonds. This amount includes \$285,250,000 of forward funding payments to the MBTA yet to be financed. To arrive at the combined capital projects fund balance, this individual fund deficit is offset by capital funds earmarked in the Central Artery Statewide Road and Bridge Infrastructure Fund of \$1,017,730,000, and \$18,749,000 in reserve for the other Capital Projects Funds.

The following Budgeted, Non-Budgeted Special Revenue and Capital Projects Funds are included in the combined totals and have individual fund deficits at June 30, 2002, as follows (amounts in thousands):

Budgeted Funds:	
Highway Fund.....	\$ 437,529
Local Aid Fund.....	1,119,125
Environmental Challenge Fund.....	797
Toxics Use Reduction Fund.....	8,416
Environmental Permitting and Compliance Assurance Fund.....	50,872
Underground Storage Tank Petroleum Product Cleanup Fund.....	19,360
Environmental Law Enforcement Fund.....	4,482
Public Access Fund.....	414
Harbors and Inland Waters Maintenance Fund.....	6,244
Marine Fisheries Fund.....	6,498
Watershed Management Fund.....	2,104
Low-Level Radioactive Waste Management Fund.....	433
Clean Air Act Compliance Fund.....	1,700
Second Century Fund.....	2,819
Child Support Penalty Fee Fund.....	498
Antitrust Enforcement Fund.....	2,901
Victim and Witness Assistance Fund.....	13,323
Intercity Bus Capital Assistance Fund.....	5,562
Leo J. Martin Recreational Fund.....	240
Children's and Seniors' Health Care Assistance Fund.....	60,784
Transitional Aid to Needy Families Fund.....	7,618
Social Services Program Fund.....	2,314
Local Consumer Inspection Fund.....	574
Total Budgeted Funds.....	<u>1,754,607</u>
Non-Budgeted Special Revenue:	
Other:	
Government Land Bank Fund.....	35,097
Mosquito and Greenhead Fly Control Fund.....	1,104
Motor Vehicle Safety Inspection Trust Fund.....	25,056
Total Non - Budgeted Funds.....	<u>61,257</u>
Capital Projects:	
General Capital Projects Fund.....	196,046
Capital Investment Trust Fund.....	957
Capital Improvements and Investment Trust Fund.....	29,858
Convention and Exhibition Center Capital Fund.....	277,192
Capital Expenditure Reserve Fund.....	192,874
Highway Capital Projects Fund.....	298,060
Local Capital Projects Fund.....	11,194
Total Capital Projects Funds.....	<u>1,006,181</u>
Total	<u>\$ 2,822,045</u>

9. MEDICAID COSTS

The Commonwealth provides medical care for low-income, elderly and other residents who qualify for such assistance under the federally-sponsored Medical Assistance Program (Medicaid). The Commonwealth pays the full cost of care and is reimbursed by the federal government for 50% of that cost. For the fiscal year ended June 30, 2002, the General Fund, Tobacco Settlement Fund and Children's and Seniors' Health Fund include \$5,259,275,000 in expenditures for Medicaid claims processed for payment.

The combined financial statements – statutory basis include Medicaid claims processed but unpaid at June 30, 2002, as accounts payable of approximately \$50,525,000. The Commonwealth estimates its total liability, as determined in accordance with GAAP, at \$718,500,000 including the amounts reported as accounts payable at June 30, 2002. This amount includes estimates of both the cost of care provided as of June 30, 2002, for which claims have not been processed and other costs. Of this amount, \$305,100,000 is expected to be reimbursed by the federal government.

10. RETIREMENT SYSTEMS

A. Primary Government

The Commonwealth is statutorily responsible for the pension benefits for Commonwealth employees (members of the State Employees' Retirement System) and for teachers of the cities, towns, regional school districts throughout the Commonwealth and Quincy College (members of the Teachers' Retirement System, except for teachers in the Boston public schools, who are members of the State-Boston Retirement System but whose pensions are also the responsibility of the Commonwealth). The members of the retirement systems do not participate in the Social Security System.

The Commonwealth has assumed responsibility for payment of cost-of-living adjustments (COLA) for the separate (non-teacher) retirement systems of its cities, towns and counties, granted in fiscal year 1997 and prior. The Commonwealth is statutorily required to have an actuarial valuation once every three years and every two years on a GAAP basis.

B. Plan Descriptions

The *State Employees' Retirement System* (SERS) is a single employer defined benefit public employee retirement system (PERS), covering substantially all employees of the Commonwealth and certain employees of the independent authorities and agencies, including the state police officers at the Massachusetts Port Authority and the Massachusetts Turnpike Authority. The SERS is administered by the Commonwealth and is part of the reporting entity and does not issue a stand alone financial report.

The *Teachers' Retirement System* (TRS) is an agent multiple employer defined benefit PERS. The Commonwealth is a non-employer contributor and is responsible for all contributions and future benefit requirements of the TRS. The TRS covers certified teachers in cities (except the City of Boston), towns, regional school districts and Quincy College. The TRS is administered by the Commonwealth and is part of the reporting entity and does not issue a stand-alone financial report.

Certain Commonwealth employees and current retirees employed prior to the establishment of the State Employees' Retirement System are covered on a "pay-as-you-go" basis. During the year ended June 30, 2002, the Commonwealth's pension expenditure included payments totaling \$17,374,000 to current retirees employed prior to the establishment of the current plans and the non-contributory plans.

The *State – Boston Retirement System* (SBRS) is a hybrid multiple employer defined benefit PERS. SBRS provides pension benefits to all full-time employees upon commencement of employment with any of the various government agencies covered by SBRS. The Commonwealth is a non-employer contributor and is only responsible for the actual cost of pension benefits for SBRS participants who serve in the City of Boston's School Department in a teaching capacity (BTRS). The cost of pension benefits of the other participants is the responsibility of the City of Boston. SBRS is not administered by the Commonwealth and is not part of the reporting entity and a stand-alone financial report is not available.

The policy for post-retirement benefit increases for all retirees of the SERS, TRS, BTRS and COLA of local governments is subject to legislative approval.

Membership – Membership in SERS, TRS and BTRS as of January 1, 2002, the date of the most recent valuation, is as follows:

	<u>SERS</u>	<u>TRS</u>	<u>BTRS</u>
Retirees and beneficiaries			
currently receiving benefits.....	44,313	34,970	2,593
Terminated employees entitled to			
benefits but not yet receiving them....	2,842	N/A	128
Subtotal.....	<u>47,155</u>	<u>34,970</u>	<u>2,721</u>
Current employees:			
Vested*.....	45,566	46,637	3,621
Non-vested*.....	42,952	42,790	2,656
Subtotal.....	<u>88,518</u>	<u>89,427</u>	<u>6,277</u>
Total.....	<u>135,673</u>	<u>124,397</u>	<u>8,998</u>

* Estimated

C. Benefit Provisions

Massachusetts General Laws established uniform benefit and contribution requirements for all contributory PERS. These requirements provide for retirement allowance benefits up to a maximum of 80% of a member's highest three-year average annual rate of regular compensation. Benefit payments are based upon a member's age, length of creditable service, and group creditable service, and group classification. The authority for amending these provisions is with the Legislature.

Members become vested after ten years of creditable service. A superannuation retirement allowance may be received upon the completion of twenty years of service or upon reaching the age of 55 with ten years of service. Normal retirement for most employees occurs at age 65; for certain hazardous duty and public safety positions, normal retirement is at age 55.

D. Funding Progress

During FY01, the Legislature passed Chapter 114 of the Acts of 2000, which modified Chapter 32 of the General Laws. This modification became effective on July 1, 2001. In Chapter 114, teachers who are members of the State Teachers Retirement System, or teachers who are members of the State – Boston Retirement System before 1975, who resigned or took an unpaid leave of absence because of maternity leave will be allowed to “buy back” into the fund up to a maximum of four years. The member must pay the amount determined by the Retirement Board by December 31, 2001 to qualify, as long as the member has worked longer than ten years. If the member completes ten years of service after December 31, 2001, payment can be made within 18 months of completion of ten years of service. In addition, the law creates a superannuation retirement benefit program for all teachers hired on or after July 1, 2001. This program has a contribution rate of 11 percent of regular compensation. To be eligible for the alternative benefit at retirement, the teacher must have completed thirty years of eligible service. All previous members may elect to participate in the program, as long as they participate with the equivalent of a minimum of five years of employee contributions at the new rate. If the member retires before five years, the teacher must pay into the system, the amount that would have been paid in one lump sum, or in installments as the Board may prescribe. The alternative benefit is calculated as the percentage of average compensation determined under the current formula increased by 2% of the average annual compensation for each full year of service in excess of 24 years. The election to participate is irrevocable.

The SERS, TRS and BTRS actuarial determined contributions were computed as part of the actuarial valuation as of January 1, 2001. These assumptions remained the same as of the January 1, 2002 valuation. The Commonwealth has revised actuarial assumptions used in the calculation of contribution requirements and Unfunded Actuarial Liability (UAL.) The revised actuarial assumptions are the result of an experience study commissioned by the Commonwealth for the period 1995 to 1999 concluded in FY01. The Commonwealth has fully phased-in its UAL from a market value of assets to an actuarial valuation of assets. The actuarial value of assets used to derive the UAL from January 1, 1990 to January 1, 1996 reflects the market value of plan assets. To reduce the potential volatility of the market value approach, in the January 1, 1998 actuarial valuation, the Commonwealth began implementing a method that averages realized and unrealized asset gains and losses over 5 years.

Therefore, gains and losses in a given year are recognized over a five-year period. On January 1, 1998, the Commonwealth began phasing in this methodology and used 97% of market value as the actuarial value of assets. This methodology was fully phased in as of January 1, 2001. The most significant assumptions for the actuarial valuation are investment return and rate of salary increase. The valuation as of January 1, 2002 assumes an investment return rate of 8.25% per year. The salary increase is based on years of service and it varies by age and service groups. Other assumptions include mortality, disability, turnover and retirement rates, along with cost of living increase.

The following table presents the schedule of funding progress as presented in the seven most recent actuarial valuations at the dates indicated (amounts in thousands):

Actuarial Valuation as of January 1	Annual Required Contribution (ARC)	Interest on NPO	Amortization of NPO	Pension Cost	Actual Contribution Made	Net Pension (Obligation) Asset (NPO)	% of ARC Contributed	% of Pension Cost Contributed
State Employees' Retirement System								
2002	\$ 215,795	\$ (111,506)	\$ (92,152)	\$ 196,441	\$ 266,660	\$ 1,421,811	124 %	136 %
2001	275,204	(109,731)	(133,387)	298,861	320,381	1,351,592	116	107
2000	352,084	(108,400)	107,190	350,873	367,000	1,330,071	104	105
1999	319,454	(103,188)	98,556	314,822	378,000	1,313,944	118	120
1998	261,255	(83,446)	77,180	254,989	494,289	1,250,766	189	194
1997	246,037	(65,478)	41,889	222,448	463,590	1,011,466	188	208
1996	232,158	(46,918)	29,523	214,763	433,114	770,324	187	202
1995	249,640	(31,639)	19,614	237,615	417,361	551,973	167	176
1994	266,564	(18,448)	9,152	257,268	398,900	372,227	150	155
1993	243,587	(5,539)	2,694	240,742	402,100	230,595	165	167
1992	252,687	136	(65)	252,758	323,700	69,237	128	128
Teachers' Retirement System								
2002	411,225	(82,377)	(68,079)	396,927	410,143	1,011,729	100	103
2001	475,053	(78,498)	(95,421)	491,976	539,000	998,513	113	110
2000	480,873	(79,487)	78,599	479,985	468,000	951,489	97	98
1999	373,777	(70,312)	67,155	370,620	481,826	963,474	129	130
1998	315,474	(59,126)	54,686	311,034	446,619	852,267	142	144
1997	245,426	(44,832)	28,681	229,275	418,519	716,682	171	183
1996	232,403	(30,311)	19,073	221,165	392,003	527,439	169	177
1995	277,343	(24,002)	14,880	268,221	342,441	356,601	123	128
1994	247,460	(15,975)	7,925	239,410	322,100	282,381	130	135
1993	225,838	(9,946)	4,837	220,729	296,100	199,691	131	134
1992	223,041	(4,996)	2,384	220,429	282,300	124,320	127	128
Boston Teachers Retirement System								
2002	940,003	(67)	(56)	93,992	51,833	41,343	6	55
2001	66,820	1,542	1,875	66,488	86,000	815	129	129
2000	58,266	448	(443)	58,271	45,000	18,697	77	77
1999	53,453	(989)	944	53,409	36,000	5,426	67	67
1998	48,795	(2,114)	1,995	48,636	35,000	11,983	72	72
1997	34,621	(2,082)	1,332	33,871	35,000	25,619	101	103
1996	32,908	(1,860)	1,171	32,219	34,822	24,490	106	108
1995	28,168	(1,816)	1,126	27,478	28,000	21,887	99	102
1994	22,448	(1,216)	603	21,835	28,000	21,365	125	128
1993	20,463	(650)	316	20,129	27,200	15,200	133	135
1992	26,530	(634)	303	26,199	26,400	8,129	100	101

E. Pension Actuarial Valuation

The Commonwealth's pension actuarial valuation was performed as of January 1, 2002 pursuant to Chapter 32 of the General Laws of the Commonwealth of Massachusetts and based on the plan provisions at that time.

F. Contributions Required and Contributions Made

The Commonwealth was financially responsible for the COLA granted to participants in the 104 retirement systems of cities, towns and counties in fiscal year 1997 and prior fiscal years. Chapter 17 of the Acts of 1997 effective for fiscal year 1998 transferred the responsibility for funding COLAs for separate (non-teacher) retirement systems of cities and towns to the respective system. Any future COLA granted by the Legislature to employees of these plans will be the responsibility of the individual system. The individual employer governments are also responsible for the basic pension benefits. The retirement systems are not administered by the Commonwealth and are not part of the reporting entity. The actuarial accrued liability for COLA as of January 1, 2002 was \$730,000,000.

The retirement systems' funding policies have been established by Chapter 32 of the Massachusetts General Laws. The Legislature has the authority to amend these policies. The annuity portion of the SERS, TRS and BTRS retirement allowance is funded by employees, who contribute a percentage of their regular compensation – 5% for those hired before January 1, 1975, 7% for those hired from January 1, 1975, through December 31, 1983 and 8% for those hired on or after January 1, 1984, plus an additional 2% of compensation above \$30,000 per year for those hired on or after January 1, 1979. Regular employees and state police hired after June 30, 1996 are required to contribute 9% and 12% respectively of their regular compensation plus an additional 2% of compensation above \$30,000 per year. Costs of administering the plan are funded out of plan assets.

The Commonwealth's contribution for the pension benefit portion of the retirement allowance of SERS and TRS and required payments to cover BTRS and COLA contributions were originally established on a "pay-as-you-go" basis. As a result, amounts were appropriated each year to pay current benefits, without a systematic provision to fully fund future liabilities already incurred. Beginning in fiscal year 1988, the Commonwealth enacted the Pension Reform Act of 1987 and addressed the unfunded liability of SERS, TRS and its participation in SBRS and its COLA obligation. Chapter 32, Section 22C of General Laws enacted in 1998 calls for the payment of normal cost plus an amortization payment of UAL such that the UAL is reduced to zero by June 30, 2018.

This legislation also directs the Secretary of Administration and Finance to prepare a funding schedule to meet these requirements, and to update this funding schedule every three years on the basis of new actuarial valuation reports prepared under the Secretary's direction. Any such schedule is subject to legislative approval. If a schedule is not so approved, payments are to be made in accordance with the most recently approved schedule. The current legislatively approved funding schedule, a valuation as of January 1, 1999, was filed by the Secretary of Administration and Finance on March 1, 2000 has been deemed approved by the Legislature. Under the current schedule proposed on March 1, 2002, the amortization payments are designed to eliminate the unfunded liability by fiscal year 2023. Contributions by the Commonwealth of \$795,782,000 were made during the fiscal year ended June 30, 2002. Of this amount \$49,772,000 represents payments for COLA granted to participants in retirement systems of cities, towns and counties.

GAAP requires that pension expenditures (costs) be based on an acceptable actuarial cost method and that they be not less than:

- Normal cost plus amortization of net pension obligation cost
- Interest and amortization on any unfunded prior service costs

On May 17, 2002, the Governor signed into law a bill that extended the Commonwealth's pension funding schedule to 2023, and reduced the FY02 pension appropriation.

The funding schedule discussed above follows an acceptable actuarial funding methodology to compute normal cost and the unfunded accrued actuarial liability.

The following table presents the schedule of employer contributions (amounts in thousands):

Actuarial Valuation as of January 1	Annual Required Contribution (ARC)	Interest on NPO	Amortization of NPO	Pension Cost	Actual Contribution Made	Net Pension (Obligation) Asset (NPO)	% of ARC Contributed	% of Pension Cost Contributed
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1996	232,158	(46,918)	29,523	214,763	433,114	770,324	187	202
1995	249,640	(31,639)	19,614	237,615	417,361	551,973	167	176
1994	266,564	(18,448)	9,152	257,268	398,900	372,227	150	155
1993	243,587	(5,539)	2,694	240,742	402,100	230,595	165	167
1992	252,687	136	(65)	252,758	323,700	69,237	128	128
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2001	475,053	(78,498)	(95,421)	491,976	539,000	998,513	113	110
2000	480,873	(79,487)	78,599	479,985	468,000	951,489	97	98
1999	373,777	(70,312)	67,155	370,620	481,826	963,474	129	130
1998	315,474	(59,126)	54,686	311,034	446,619	852,267	142	144
1997	245,426	(44,832)	28,681	229,275	418,519	716,682	171	183
1996	232,403	(30,311)	19,073	221,165	392,003	527,439	169	177
1995	277,343	(24,002)	14,880	268,221	342,441	356,601	123	128
1994	247,460	(15,975)	7,925	239,410	322,100	282,381	130	135
1993	225,838	(9,946)	4,837	220,729	296,100	199,691	131	134
1992	223,041	(4,996)	2,384	220,429	282,300	124,320	127	128
Boston Teachers Retirement System								
2002	940,003	(67)	(56)	93,992	51,833	41,343	6	55
2001	66,820	1,542	1,875	66,488	86,000	815	129	129
2000	58,266	448	(443)	58,271	45,000	18,697	77	77
1999	53,453	(989)	944	53,409	36,000	5,426	67	67
1998	48,795	(2,114)	1,995	48,636	35,000	11,983	72	72
1997	34,621	(2,082)	1,332	33,871	35,000	25,619	101	103
1996	32,908	(1,860)	1,171	32,219	34,822	24,490	106	108
1995	28,168	(1,816)	1,126	27,478	28,000	21,887	99	102
1994	22,448	(1,216)	603	21,835	28,000	21,365	125	128
1993	20,463	(650)	316	20,129	27,200	15,200	133	135
1992	26,530	(634)	303	26,199	26,400	8,129	100	101

The total contributions required for SERS, TRS and SBRS are based on the entry age normal cost method using the same actuarial assumptions used to compute the net pension obligation.

F. *Post-retirement Health Care and Life Insurance Benefits*

In addition to providing pension benefits, under Chapter 32A of the Massachusetts General Laws, the Commonwealth is required to provide certain health care and life insurance benefits for retired employees of the Commonwealth, housing authorities, redevelopment authorities, and certain other governmental agencies. Substantially all of the Commonwealth's employees may become eligible for these benefits if they reach retirement age while working for the Commonwealth. Eligible retirees are required to contribute a specified percentage of the health care benefit costs which is comparable to contributions required from employees. The Commonwealth is reimbursed for the cost of benefits to retirees of the eligible authorities and non-state agencies. The Commonwealth recognizes its share of the costs of providing these benefits when paid. These payments totaled approximately \$236,041,000 for the fiscal year ended June 30, 2002. There are approximately 49,900 participants eligible to receive benefits at June 30, 2002.

11. COMMITMENTS

A. *Regional Transit Authorities*

Under Chapter 161B of the General Laws, the Commonwealth is obligated to provide annual subsidies to certain regional transit authorities for contract assistance, debt service assistance and their net cost of service deficiencies. The Commonwealth recovers a portion of these payments through assessments to the cities and towns served. During FY02, net expenditures were \$17,602,000. In addition, for FY02, the Commonwealth appropriated \$18,423,000 to the regional transit authorities to cover net costs of service for the calendar year ended December 31, 2001.

B. *MBTA and Other Authorities*

The Commonwealth continues to guarantee certain Massachusetts Bay Transportation Authority (MBTA) debt outstanding at June 30, 2002, totaling \$3,264,345,000. The amount represents the residual balance of Commonwealth guaranteed debt that existed prior to the forward funding.

The MBTA's forward funding legislation provides for the MBTA to issue general obligation, revenue or other debt secured by a pledge or conveyance of all or a portion of revenues, receipts or other assets or funds of the MBTA. This new debt is not backed by the full faith and credit of the Commonwealth. Finally, the MBTA will not receive any principal or interest subsidies from the Commonwealth for the repayment of either the prior debt or new debt of the MBTA beyond the pledged revenues.

In addition to the MBTA, the Commonwealth guarantees debt of a number of Public Authorities. At June 30, 2002, the aggregate outstanding debt for which the Commonwealth is obligated to provide contract assistance support totaled approximately \$169,312,000 long-term and \$96,856,000 short-term.

In addition, the Commonwealth guarantees the debt of certain local governments and public higher education building authorities but does not provide contract assistance. The guaranteed long-term debt outstanding at June 30, 2002 was approximately \$381,794,000.

At June 30, 2002, the Commonwealth had commitments of approximately \$1,657,409,000 related to ongoing construction projects. The majority relate to construction funding for the Central Artery/Tunnel Project. The Central Artery/Tunnel Project continues to anticipate federal participation and payments from the Massachusetts Turnpike Authority (MTA) and the Massachusetts Port Authority (MassPort).

On August 17, 2000, the Route 3 North Transportation Improvements Association issued Commonwealth of Massachusetts Lease Revenue Bonds, Series 2000, in the aggregate principal amount of \$394,305,000, payable from lease payments to be appropriated annually by the Commonwealth through fiscal 2033. On April 26, 2002, the Association sold \$18,700,000, followed a week later on May 2, 2002 by \$294,000,000 of Variable Rate Demand Bonds, both of which were used to refund a portion of the original Series 2000 bonds and to fund additional expenses of the project. The Commonwealth's cash flow commitment due to the refunding will be reduced by \$6.1 million for the life of the bonds plus any amount remaining due to cost savings at time of the completion of construction.

C. *Saltonstall Building*

On July 19, 2000, after reviewing proposals received from various development teams to redevelop the Saltonstall State Office Building, the Governor filed legislation that would authorize the Massachusetts Development Finance Agency (MDFA) to undertake the area's redevelopment. The provisions of the Governor's bill were added to the bond authorization legislation approved August 10, 2000 relating to preservation and management of the Commonwealth's real property assets. Under the provisions relating to the Saltonstall Building, the building is to be leased by the MDFA for a lease term of up to 50 years, with extension terms permitted for an aggregate of 30 more years). The MDFA will renovate the building and lease half of it back to the Commonwealth for office space and related parking (for a comparable lease term). The remainder of the building is to be redeveloped as private office space, as well as private housing units and retail establishments. Upon completion, the Commonwealth will be obligated for future lease payments for the space it rents.

D. *Central Artery / Tunnel Project*

The Central Artery / Tunnel Project is the largest single component of the Commonwealth's capital program according to the finance plan filed as of October 1, 2002. The current cost estimate is \$14.625 billion, an increase of \$150,000,000 from the October 1, 2001 plan. The largest components of the increase were related to the disposition of the project's headquarters. Both plans include a maximum obligation of \$8.549 billion from the federal government. Project milestones have been reviewed to include a nine-month extension to the I-90 opening and a four-month extension to the I-93 opening. The I-90 opening may be delayed further due to a major leak in the Fort Point Channel Tunnel discovered in October 2001. The finance plan is currently under review.

To make up for the \$150,000,000 increase, the Governor filed a bill to raise the bonding authority for the project in place under Chapter 87 of the Acts of 2000 from \$1.350 billion to \$1.500 billion. The increase, once bonded, will be reported within the Central Artery Statewide Road and Bridge Infrastructure Fund.

In connection with the Central Artery / Tunnel Project, on May 8, 2000, the State Treasurer's office was advised that the staff of the Securities and Exchange Commission (SEC) is conducting a formal investigation in the matter of

“Certain Municipal Securities/Massachusetts Central Artery (B-1610.)” This is pursuant to a formal order of private investigation issued by the SEC. At this time no information is available about the likelihood of the loss.

12. CONTINGENCIES

A number of lawsuits are pending or threatened against the Commonwealth, which arise from the ordinary course of operations. These include claims for property damage and personal injury, breaches of contract, condemnation proceedings and other alleged violations of law. For those cases in which it is probable that a loss will be incurred and the amount of the potential judgment can be reasonably estimated or a settlement or judgment has been reached but not paid, the Attorney General estimates the liability to be approximately \$41,500,000 to be paid during FY03. No accrual has been made for this amount in the combined financial statements – statutory basis.

Under the statutory basis of accounting, workers’ compensation costs are recognized when claims are presented and paid. The Commonwealth’s outstanding liability for such claims at June 30, 2002 is estimated to be \$267,600,000, of which approximately \$39,400,000 is expected to be paid during FY03. No accrual has been made for these amounts in the combined financial statements – statutory basis.

The Commonwealth receives significant financial assistance from the federal government. Entitlement to these resources is generally contingent upon compliance with terms and conditions of the grant or reimbursement agreements and with applicable federal regulations, including the expenditure of the resources for eligible purposes. Substantially all federal financial assistance is subject to financial and compliance audits. Any disallowances become liabilities of the fund which received the assistance. At June 30, 2002, the Commonwealth estimated that liabilities, if any, which may result from such audits are not material.

Chapter 200A of the Massachusetts General Laws, the Commonwealth’s Abandoned Property Law, requires deposit of certain unclaimed assets into a managed Fiduciary Fund. These unclaimed assets, less \$4,987,000, which is expected to be reclaimed and paid in fiscal year 2003, are to be remitted to the General Fund each June 30, where it is included as miscellaneous revenue. Amounts remitted during FY02 totaled approximately \$87,757,000. Since inception, approximately \$1,056,364,000 has been remitted. A portion of this amount represents a contingency, because claims for refunds can be made by the owners of the property.

A. Tobacco Settlement

A Master Settlement Agreement (MSA) was executed in November of 1998 between five tobacco companies and 46 states, including the Commonwealth. The MSA called for, among other things, annual payments to the states in perpetuity. These payments have been estimated to total more than \$200 billion over the first 25 years, subject to various offsets, reductions, and adjustments.

In FY02, the Commonwealth received approximately \$304,518,000 or 91% of the estimated amounts shown in the agreement. Of that amount approximately \$152,259,000 was transferred to the Tobacco Settlement Fund, a budgeted fund, plus an additional \$2,469,000 in interest earnings were transferred. The remainder was deposited into the Health Care Security Trust Fund, a non-budgeted fund. The amount transferred to the Tobacco Settlement Fund was

increased in FY02 to 50% of the settlements received during the year due to changes made as part of the FY02 General Appropriation Act. In addition, \$60,000,000 was transferred during the year from the funds received previously under the settlement to the General fund due to legislation passed in June 2002. However, the majority of expenditures from the fund this year were for Health and Human Services, Elder Affairs and Medicaid costs.

The amounts that might be payable, if any, by the Commonwealth for legal costs relating to the tobacco litigation cannot be determined at this time. The outside attorneys for the Commonwealth were awarded approximately \$775,000,000 in fees to be paid over time by the tobacco companies and, therefore, were not to be paid out of the Commonwealth's award. The outside attorneys have notified the Attorney General that they reserve their right to submit a claim to the Commonwealth for the difference between the \$775,000,000 and 25 percent of the Commonwealth's settlement payments.

13. NON-TAX REVENUE INITIATIVES

Chapter 653, Acts of 1989, amended Chapter 29 of the Massachusetts General Laws by adding Sections 29D and 29E, which authorize certain non-tax revenue initiatives and require reporting thereon, as follows.

A. Debt Collection

Pursuant to Massachusetts General Laws Chapter 29, Section 29D, Chapter 7A Section 8, allows private debt collection agencies to engage in debt collection for the Commonwealth. The fees paid are contingency based from the proceeds collected. Collections and fees paid during FY02 were:

<u>Department Collectors</u>	<u>Collections</u>	<u>Fees</u>
Allen Daniel Associates.....	\$ 367,763	\$ 67,321
Collection Company of America.....	1,049,036	250,541
Delta Management Associates, Inc.....	291,993	57,880
Glenn Associates, Inc.....	619,737	119,376
Gragil Associates, Inc.....	88,083	18,170
NCO Financial Systems, Inc.....	1,511	59
OSI Collection Services, Inc.....	912,376	187,350
Walker Associates Inc.....	441,279	62,023
Windham Professionals.....	1,404,053	323,410
Total.....	<u>\$ 5,175,831</u>	<u>\$ 1,086,130</u>

Under the same program, the following amounts were collected and fees paid for institutions of higher education:

<u>Department Collectors</u>	<u>Collections</u>	<u>Fees</u>
Allen Daniel Associates.....	\$ 344,710	\$ 62,800
Collection Company of America.....	762,446	188,264
Delta Management Associates, Inc....	283,842	56,260
Glenn Associates, Inc.....	619,737	119,376
Gragil Associates, Inc.....	506	126
NCO Financial Systems, Inc.....	1,511	59
OSI Collection Services, Inc.....	418,679	84,129
Windham Professionals.....	75,874	17,195
Total.....	<u>\$ 2,507,305</u>	<u>\$ 528,209</u>

B. Revenue Maximization

Pursuant to Massachusetts General Law Chapter 29 Section 29E, contractors were engaged on a contingent fee basis to assist several of the Commonwealth's departments in the identification and collection of federal and other revenues. During FY02, approximately \$171,715,000 was collected through such efforts. After contractor payments of \$35,044,000 the Commonwealth received \$136,671,000. Included in these Revenue Maximization numbers is \$26,583,000 for administrative services provided by the University of Massachusetts Medical School to support efficiencies associated with the Department of Medical Assistance.

C. Revenue Optimization

Pursuant to Chapter 159 Section 333 of the FY01 Budget, contractors were engaged on a contingent fee basis to assist several of the Commonwealth's departments in the identification and collection of federal and other non-tax revenues. This program differs from the Revenue Maximization Program in that it authorized departments to receive a department incentive distribution if they are successful in generating new revenue and additional fiscal program goals are met. During FY02, approximately \$7,567,000 was collected through such efforts. After contractor payments of \$405,000 and other expenses of approximately \$517,000, the Commonwealth reported a net revenue of approximately \$6,646,000 in the General Fund. Although the Revenue Optimization Campaign did exceed the department incentive allocation goals the FY02 department incentive appropriation was not funded.

D. Cost Avoidance

Pursuant to Chapter 159 of Section 360 of the FY01 Budget, the Office of the State Comptroller was authorized to engage private vendors for the purpose of identification and pursuit of cost saving/avoidance opportunities. In FY02, estimated total cost avoidance based on actuarial calculations was approximately \$66,529,000 and fees paid to consultants were approximately \$2,235,000. The Commonwealth had a total cost saving/avoidance of approximately \$64,295,000.

E. Intercept

Intercept is authorized by Massachusetts General Laws. Intercept is an automated process that offsets Commonwealth payments to delinquent receivables that have been approved by the Office of the State Comptroller. During FY02 the Intercept process was enhanced by using the web-based technology to accept debt files from institutions of higher education. In FY02, the Commonwealth collected approximately \$3,654,000 of which approximately \$798,000 was on behalf of institutions of higher education.

F. Utility Audits

Pursuant to Massachusetts General Law Chapter 29 §29E contractors were engaged on a contingent fee basis to provide telecommunication service audits to eligible entities of the Commonwealth. In FY02, approximately \$371,000 in overcharges were successfully identified and recouped, of which approximately \$125,000 was paid to contractors.

14. SUBSEQUENT EVENTS

On July 31, 2002, the FY03 General Appropriation Act was passed. The budget was based on a tax revenue estimate of \$14.0 billion net of the amounts due to the MBTA, plus \$1.2 billion in estimated tax increases. It also includes a tax amnesty program, which is expected to increase revenue collections by an estimated \$43 million. Appropriations total \$23 billion, exclusive of \$350 million of Medicaid related health care spending that was moved off-budget. After accounting for this spending, the FY03 General Appropriation Act increases spending by 2% over FY02 spending. The Act eliminates eligibility for 50,000 Medicaid patients as of April 1, 2003. It also uses 100% of the tobacco settlement payment to be received in FY03 for current operations.

FY03 budgeted tax revenues for the quarter ending September 30, 2002 are an estimated \$86 million behind the same quarter in FY02. On October 10, 2002, the Governor invoked her authority under Massachusetts General Laws, Chapter 29, Section 9c, cutting \$202 million from budgeted spending.